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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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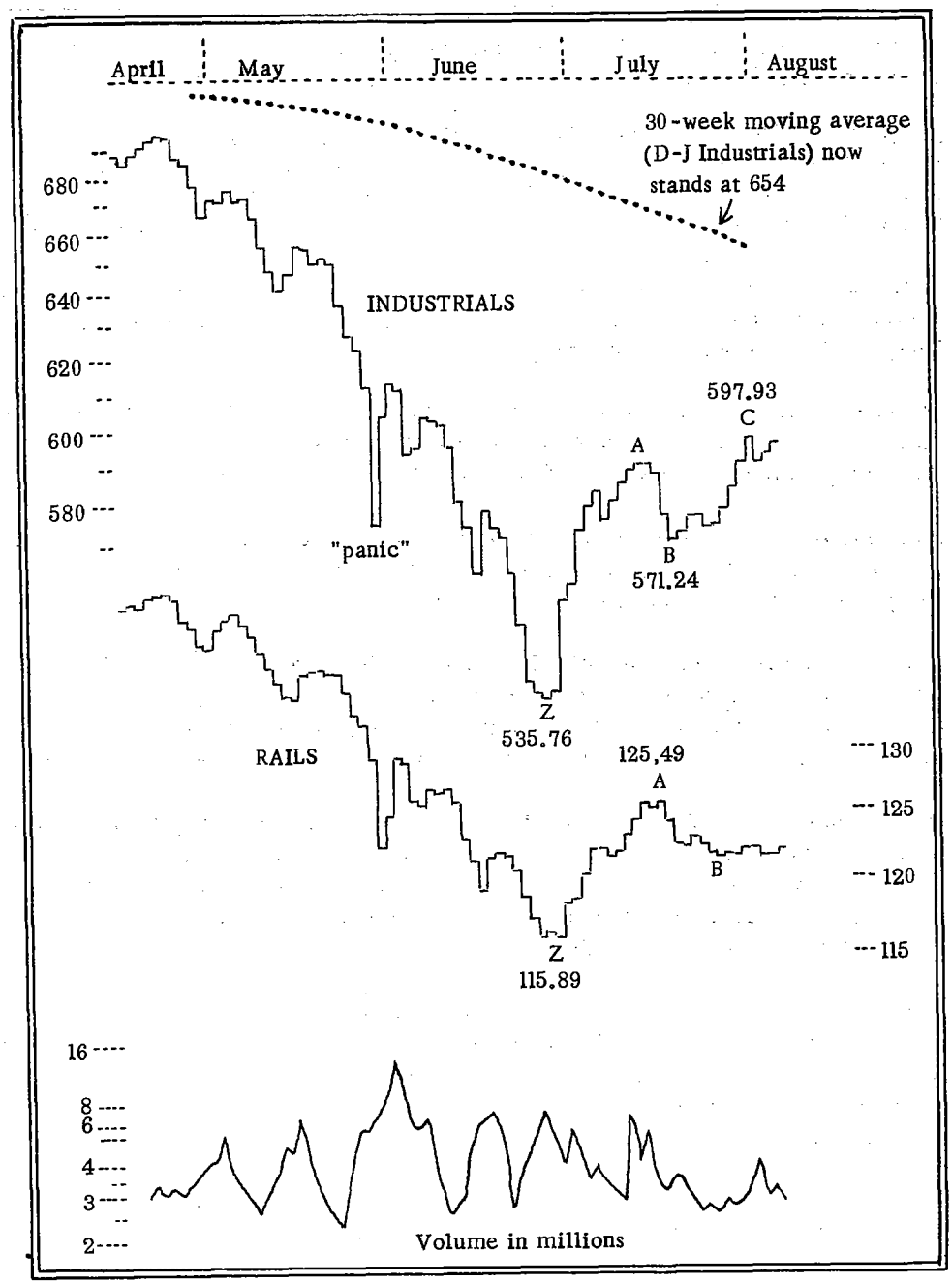
Over the past month this writer has been wrestling with the unenviable task of analyzing a secondary correction of the 1962 collapse. This service of Letters was never intended to be a personal advice service or a "tip sheet." I have tried to present some of the implications of Dow's classic Theory, and I have augmented these studies with whatever additional material I thought would be helpful to subscribers. All this notwithstanding, I am now receiving a daily flood of mail from subscribers. who ask every sort of question. One writes that he has "a 10 point profit in Beckman -- should I sell or buy more?" Another states that he 'scalped' a four point profit in General Electric. "Did I do right, or should I buy back at 67?" A third complains that he missed the "buy-spot" at point B. "Is it too late to buy now?" These are questions for brokers or subscribers themselves to answer. I simply cannot solve all personal problems (nor, I am sure, would the majority of subscribers agree with my decisions if I could manage to act for each individually).



During the last three months, subscriptions to these Letters have risen about 20%, which is a strange phenomenon in view of the uncertainty and perplexity of the present market. Many questions asked by new subscribers have been answered in preceding Letters, and I will attempt to answer additional questions in forthcoming mailings.

THE MARKET On July 24 Rails penetrated their minor low point at B. This action was discussed in Letter 188, and I stipulated (page 4) that "a persistent refusal by Industrials to penetrate their own B level (571.24) would be a hopeful sign and would suggest that the senior Average was preparing for another try at the recent recovery peak."

Following a refusal by Industrials to break below B, that Average moved sharply higher. On July 30 the senior Average rose above its preceding peak to a new recovery high of 597.93. The new recovery high was not confirmed by Rails. In fact, during the 26 point Industrial rally (B-C) which lasted from July 18 to July 31, Rails actually ended with a net loss of 46¢ (see chart). This obvious danger signal was discussed on page 2 of Letter 188. "If the Rails

 'flatten out' during the next rally," it was stated, "watch out."

No one can know, at this time, whether the upside momentum of the market has been spent -- or whether the Averages are pausing, preparatory to the next rise. Without meaning to be prematurely bearish, I believe it is worth stating that many secondary reactions (in a bear market) terminate with the formation of a "dragging" sideways movement (these structures are called "lines" by Dow Theorists). In bear markets most lines represent areas of informed distribution. During bull markets the majority of lines denote areas of informed accumulation.

If a line now appears in the Averages, I believe the chances are that the secondary (upward) reaction which began on June 26 is in its last stages, and that the next major movement will be down.

Over the last 13 trading days, the Rail Average has fluctuated within the extremely narrow area of two points. While it is too early to tell, the movements of Industrials also suggest the possibility that the senior Average is forming a line. Penetration by the two Averages above or below the line limits generally affords an excellent forecast of the next major movement of stock prices. However, Rhea stated that during bear markets, upside penetrations of lines were to be treated with care (since such penetrations are against the primary trend, and they may be deceptive), but joint downside penetrations on increasing volume offer valuable opportunities for those who are inclined towards the short side.

Of interest is the fact that the advance-decline ratio (as in the case of the Rails) has refused to confirm the latest Industrial peak at C. Therefore, a possible final upthrust to a new recovery high by Industrials (unless confirmed by Rails and the A-D ratio) would appear extremely dangerous. Such a move could take Industrials into the much desired "600 area" (amid thunderous applause from Wall Street). In this writer's opinion, however, another unconfirmed Industrial high could easily mark the beginning of the third primary leg of the bear market.

THE BIG PICTURE A knowledgeable subscriber writes: "I am wondering if we are not all inclined to regard the bear market of 1929-32 as the criterion for all bear markets. Certainly there was no post-panic rally of any consequence in 1937. After fooling around for six months and one last plunge (1938), the market went up 50% in six months, with a series of baby bull and bear markets following -- and the ultimate low before the next major advance being made four years later.

"The same thing happened in 1946. There was no real secondary recovery of great consequence,but a gradual rise and then a series of baby bull and bear markets until the ultimate low (prior to the next major advance) occurring three years later (in 1949)." (C.V., Yakima, Washington).

Of course, the same thing could take place again now. The Averages could work up to 635 (the halfway level of the 1962 decline) or even higher, then sink back towards the 1962 lows. There could even be a frustrating series of baby bull and bear swings, lasting perhaps two or three years, prior to the next major advance.

An interesting "test" of the situation, however, should come between now and October. This period will see the current rise move into its second to fourth month, and this will mean that the retracement of the 1962 collapse will have "lived long enough" to qualify as a mature secondary reaction.

If a deteriorating economic situation has been fully discounted by the recent 200 point drop in Industrials (and the 33 point drop in Rails), it is probable that the lows of June 24 will stand as the extreme lows of the bear market. On the other hand, if the forthcoming economic picture is to turn from grey to black in late 1962 or early 1963, we will undoubtedly receive evidence of it in the price structure -- via a joint penetration of the Averages below the June lows.

My own feeling is that the back of the bull market has been irreparably broken -- but that the unexpected could still occur. We could have "a false bull market" such as the one that took place in 1930. A tax cut (which is now extremely doubtful) might serve to produce an unexpectedly violent market rise. Devaluation might stir up the dying embers of inflation, but this possibility must also be considered a dim one for the near future (if we take President Kennedy's oaths to defend the dollar as being anything like reliable).

Thus, as far as a secondary "blow-off " is concerned, I am dubious but have not dismissed it altogether. It should be remembered however, that markets in the old days were not subject to a continual barrage of Governmental manipulations and "panaceas". If part of the current 17 million investment population in this nation decided that President Kennedy had it in his power to create "another bull market", alot of ammunition could be set off before the primary bear market reasserted its downward force.

During the 1962 decline, almost all stocks moved (lower) together -- a performance which astounded many a New Era bull. We could now witness a period of selectivity in which a few individual stocks would bathe in the limelight (and the familiar cry of "it's a market of stocks" would again undoubtedly ring through the land).

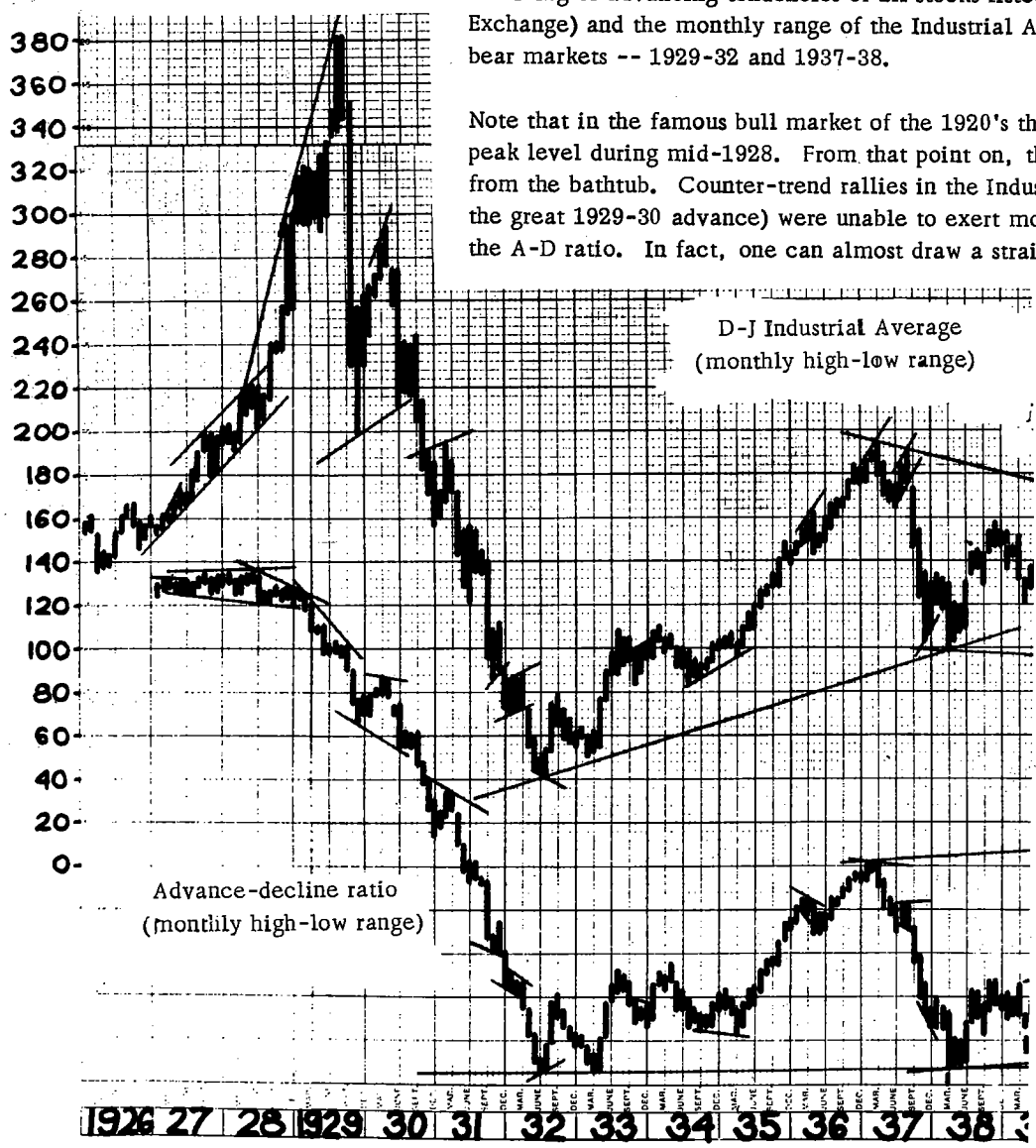
All things considered, I still see the action since June 24 as part of a normal secondary retracement of a panic-collapse. If the unexpected does occur, we will deal with it, but as things now stand it would be well to place the probable termination of the current secondary advance in the 597-650 area.

I continue to view the yield chart (see Letter 188) as a critical piece of evidence favoring the long-term bearish view. Traders are seldom interested in such material, but in the long run the great profits are not made by traders -- they are made by investors who have the patience to wait for real values, and then load up with equity which nobody wants in preparation for a bull market that nobody believes in.

BEAR MARKET ACTION Picture a child playing in a bathtub with a rubber ball. During a bull market the water in the tub is rising. If we let the ball represent the Industrial Average and the water in the tub represent the mass of stocks (advance-decline ratio), we have a fairly good picture of bull market action. As the child splashes about, the water in the tub may surge and churn, but since the tub is filling, the waterline will steadily rise. The splashes will often send the ball bouncing right out of the water, but each time the ball will return to the water level.

In a bear market the reverse action is seen. Here the stopper has been removed from the tub and the waterline is steadily receding. The splashes may temporarily obscure the situation, and the ball will again bounce out of the water. But each bounce of the ball is from lower levels -- as the waterline continues its persistent decline.

The bouncing ball often captures our sole attention during a bear (or bull) market, and these bounces can be likened to secondary reactions against the primary or main movement of the waterline in the tub. With this illustration in mind, it is well worth studying the rare chart (below) which depicts the monthly range of the advance-decline ratio (representing the declining or advancing tendencies of all stocks listed on the N.Y. Stock Exchange) and the monthly range of the Industrial Average through two great bear markets -- 1929-32 and 1937-38.



Note that in the famous bull market of the 1920's the A-D ratio registered its peak level during mid-1928. From that point on, the stopper was removed from the bathtub. Counter-trend rallies in the Industrial Average (including the great 1929-30 advance) were unable to exert more than a token force on the A-D ratio. In fact, one can almost draw a straight line from 1929 through all the pathetic little tops in the A-D ratio down to the 1932 lows. The great 1929-32 bear market touched bottom in mid-32, and it was not until July, August and September of 1932 that the A-D ratio was able to tack on three consecutive months of impressive rise (the tide turned bullish on July 8, 1932).

Again during the collapse of 1937-38 we see the same sagging tendencies in the great majority of stocks as represented by the A-D ratio. Note the dramatic sluggishness of the A-D ratio during the first sizable upward correction which came in late 1937, a correction which returned the Indus-dustrial Average to within

 4 points of its previous bull market peak.

What does all this add up to as far as the reader is concerned? Simply this -- it points up the difficulty of trying to capture profits during bear market rallies. There is no doubt that many traders are successful in garnering profits during a full correction of a "crash" or an extended bear market leg. But these men are patient, they control their greed, and they are aware of the odds against "bucking" the trend.

LATE NOTES (Written Monday, August 6, 10A.M. N.Y. time): On Friday Industrials pushed higher, closing within two points of their preceding peak at C (597.93). Rails rose 54¢, but remained within the "line" area described on page 2. This morning (August 6) stocks opened slightly lower with most issues fluctuating in small fractions.

The strength of the market will be gauged by the ability of inability of the Rails to (1) break above the upper limits of their line -- or above 123; (2) confirm the Industrials by rising above point A -- 125.49. A persistent refusal to do one or both will signal trouble ahead.

The trend of volume will also be worth watching carefully. So far, volume during the recovery to C has lagged behind the volume at the preceding peak at A. In general, volume should increase as successive highs are recorded, and this has not been the case so far (see chart on page 1).

STOCKS As stated in recent Letters, an increasing number of stocks are now in potential reversal formations -- mainly, reverse "head-and-shoulders" patterns. However, in glancing through hundreds of charts one thing strikes me as singular. It is that the critical volume factor is lacking on the "breakouts". Thus the charts of three leading stocks are shown below. In each case a head-and-shoulder reversal has been completed, and the horizontal "neckline" has been hurdled. Note, however, that volume has not expanded on the final upside penetration (arrows).

I do not know the full meaning of this strange phenomenon, but I do not that when such pattern are completed, volume SHOULD expand markedly on the final upside penetration. In discussing these formations, Magee ("Technical Analysis of Stock Trends") states: "Volume must be present on the penetration of the neckline, else the breakout is not to be relied upon as a decisive confirmation."

Volume has been lacking in the majority of recent breakouts. Because of this, I would rather wait until the next Letter before suggesting any new purchases. The total chart picture strikes me as rather suspicious.

Charts courtesy of Traders Research, Inc., P.O. Box 2644, St. Louis 16, Mo.